# FINANCIAL REPORTING FROM THE REFERENCE THEORIES' PERSPECTIVE

**Ph.D., Delia – Mihaela IBĂNIȘTEANU (IONASZ)**
"Valahia" University of Târgovişte, Romania
E-mail: delia.ionasz@yahoo.de

***Abstract:*** *International accounting standards are underpinned by a normative approach of accounting, in the sense that these are based on conceptual accounting framework assimilated by a theoretical framework. The conceptual framework's development is based on a priori theory, initiated by Chambers, in his article published in 1955, where he defends the need for a theory of practical accounting an a detachment from descriptive theories of an inductive approach. Developing the accounting standards on such theories is the result of deductive logic, while national regulations are based on an inductive approach. Furthermore, the wording of the national regulations concerning consolidated or social accounts is not explicitly dedicated to the privileged users of financial and accounting information. The clear position of the IAS/IFRS conceptual framework, directed to investor, places the international accounting model to the basis of agency theory.*
***Keywords****: financial reporting, accounting model, International Accounting Standards, conceptual framework, agency theory, normative theory.*
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## 1. Financial Information and Agency Theory

As early as 1776, Adam Smith admitted the existence of problems arising from the **agency** relationship, arguing that the separation between managers and owners of large corporations leads to a lower efficiency of economic organization (Charreaux, 1987).

In 1932, Berle and Means, stated in their book on modern society: "the owner who invests in a modern society delegates the management of his property to the ones that run the company. He has changed his position of independent owner of the company with the one of a simple beneficiary of capital income". This separation between the functions of ownership and decision-making is the source of corporative governance issues, which has contributed to highlighting the importance of accounting and financial information's role in what regards the agreement between shareholders/managers, or in a broader perspective, between many partners involved in the entity's activities, also called stakeholders.

Gibbins, Richardson and Waterhouse (1990) has defined financial reporting as "any deliberate disclosure of financial information, either numerical or qualitative, legal or voluntary, or through formal or informal channels" and indicates the fact that both quantitative and qualitative information has an informative value. The definition of governance we keep is the one proposed by Charreaux that exceeds the limits of shareholding vision: "governance system is a set of mechanisms that define and delineate the discretionary space of enterprises' leaders" (Charreaux, 2009).

The IAS / IFRS conceptual framework implicitly adheres to the agency model, in its simplest form, namely it is only interested in the agreement between managers and shareholders (Colasse, 2006). The analysis conducted by Jensen and Meckling (1976) regarding the agent relationship has been followed by the works of Watts (1977) and Watts and Zimmerman (1978), where a theory of financial statements is based on the agreements within the entity. Jensen and Meckling have defined the agency relationship as being "an agreement by which one or several persons (the principal(s)) hire another person (the agent) to fulfill in its/their name, some tasks inducing delegation of power in decisions-taking by the agent" (Jensen and Meckling, 1976). Although this definition is generally used as reference, Charreaux, G., (1987) proposes a new definition: "we say that an agency relationship is formed between two (or several) parties when on of these two parties, designated as agent, as the other's representative, designated as main party, in a decisional specific area". Both models are very close and appeal to notions of: contract, representation and delegation.

However, Jensen and Meckling (1976) extend agency theory in a cooperation form, including relations, not necessarily formalized through a main agent and eliminates the problem of identifying this. This theory is based on a logic borrowed from the neo-classical economic theory: an approach from the point of view of "homo economicus" and maximizing individual usefulness. Subsequently, an agency theory extended to all stakeholders was proposed in 1992 by Hill and Jones.

Regardless of authors' vision on agency theory, financial information is a key-element of the relationship between entity and its investors, whether they are shareholders of creditors. The positive agency theory can highlight potential conflicts emerging from these relationships, and the research done on this topic suggests mechanisms for solving these conflicts. Among the conflict sources, asymmetric information is visibly the most importantem and the different regulations adopted, after getting aware of the problem, contributes to the effects limitation. The conceptual basis of IAS/IFRS standards first retains the approach to "investors" of the agent relationship, while entity has implicit or explicit contractual relations, with a series of partners.

### 2. Financial Information and Normative Theory

The need for normative theory regarding the goals, scope of use, preparation and submission of financial-accounting reports, was the more necessary, since the accounting standards and regulations formulate a series of liberties concerning the fact that: an entity may also use other names for the financial statements, than those set out in standards and regulations; the entity has the discretion to derogate from regulations and submit additional information out of the need for relevance and accuracy (Ristea, 2013). Over time, many normative accounting theories have been developed by the number of well-known academics.

However, normative theories have not generally succeeded to be integrated in the accounting profession, or to be mandated in financial accounting regulations ( Deegan and Unerman, 2011).

The normative theory was formulated in the 50's by the will of an academic group as a response to the lack of accounting conceptual bases, deemed as harmful[1]. Accounting theory was at the time a "simple descriptive and classifying approach that did not allow the establishment of hierarchies between the frequently unreliable accounting principles" (Colasse, 2005). Thus, a set of requirements is developed, concerning the conduct of the accounting process (Deegan, 2001). The first conceptual framework was developed based on those elements, published in 1978, the one of American norm-setting body FASB 15. Although normative theory is interested in the users' needs for financial information, this framework is important for its well-defined goals, the financial information's contents being closely connected to the goals related to this.

The 60's are described as "golden age of a priori theorizing" by Nelson (1973) because a series of normative theories have been developed based on the users' needs for information. Dyckman and Zeff (1984) classify specialized literature from the end of the 50's in two branches of normative theory: those authors that support with pro (or con) arguments a certain "policy prescription" accounting treatment and those whose main goal is to establish the fundamentals necessary in choosing and accounting method - the "framework building" approach. The "policy prescription" approach is the first place

[1] AAA –Committee on Concepts and Standards for External Financial Reports (1977), Statement on Accounting Theory and Theory Acceptance, American Accounting Assocciation, p. 6

concerned with the general issues of assessment and outcomes, while "framework building" aims to develop a general theory of accounting (fig. no.1).

**Figure no. 1. Different trends of normative theory**

NORMATIVE THEORY OF ACCOUNTING

**Policy prescription"**
*Assessment methods in the inflationary period*
Edwards, Bell (1961)
Moonitz (1961)
Sprouse, Moonitz (1962)
Chambers (1966)

**"Framework building"**
*Developing a meta-theory*
Chambers (1955)
Mattessich (1957)

Source: own adaptation.

The "policy prescription" branch of the normative theory has been clearly influenced by the issues of value measurement, still valid, especially in Europe, after the adoptation of IAS / IFRS. The second part of the normative theory - "framework building", published at the time, aims to establish the intellectual basis of that treatments that have inspired norm-makers in the preparation of the initial conceptual framework and project of convergence between the American and the international conceptual framework.

The normative nature of Chambers has had a major impact on the norm-setting bodies in developing conceptual frameworks (Colasse, 2005). This formulates 4 assumptions as premises of developing a general theory or a "meta-theory" (Chambers, 1955) :

1. Certain organized activities are put into application by entities that exist thanks to the participants' will or cooperation.
2. These entities are rationally managed, that is – they respond effectively to the participants' expectations.
3. Monetary reporting of the transactions and relations of the entity provides a means to facilitate rational management.
4. Developing such reporting is a job task.

**Figure no. 2. The normative meaning of the performance concept**

| PERFORMANCE | OUTCOME | CONCEPT OF CAPITAL |
|---|---|---|
| **Physical capital**<br>Productive capacity<br>Measured in physical units | | **Financial capital**<br>Measured in monetary units |
| | **Nominal capital**<br>Rating at the origin value | **Invested purchasing power**<br>Rating the current value |
| **Performance**<br>The productive capacity at the end of a period exceeds the expectations of the period's beginning. | **Performance**<br>If the difference between the nominal capital at the end and beggining respectively of a period is positive. Held profits are not included in accounting. | **Performance**<br>The purchasing power at the end of a period exceeds the expectations of the periods beginning. Held profits are profits included in equity's accounting. |

Source: adapted form Platet–Pierrot, F., 2010. *L´information financiaère à la lumière d'un changement de cadre conceptual comptable: Étude du message du Président des société* *cotées françaises*. [online] Available at : <httl://tel.archives-ouvertes.fr/tel-00480501> [Accessed 1 March 2021].

Certainly, all the four sentences are to be found in the conceptual framework made by IASB. This states that the finacial statements are intended to provide information on entity's performance and finacial position for decision-making, but without explicitly defining what the performance concept "does cover".

The goals of financial reporting from the accounting normative theory perspective contributes to the indentification of different models that cover the concept of performance, particularly concerning the intended users. This theory provides an image of what a piece of financial information should include, according to the accounting model used by its formulators.

### 3. Complexity of current financial reporting model

A common critique, made by those that question the usefulness of IFRS financial statements for investors and analysts, is that the financial statements have become too complex. These state that it is difficult for investors and analysts to understand some of the information provided in the financial statements and to assess ethe relative importance of information. Some critiques refer to "excess of information".

We have identified a series of complexity sources, such as: business operations becoming more complex, complexity of regulation framework, entity's and stakeholders' change of attitudes. As the working group says, ever more complex reporting requirements are not a primary source of complexity in financial reporting, but rather a consequence of modern business operations' complexity and diverse needs of the investors. The concern for the difficulties that investors and analysts have to cope with in understanding financial statments stem, partly, in a failure to understand the financial statements prepared in accordance with IFRS.

Some critics argue that financial statements housl be easy to understand for all investors, inclusively the so-called "mum and dad investors"[1]. However, IASB has made clearly known the fact that IFRS financial statements are directed to investors, since they are quite sophisticated financially. In its conceptual framework from 2010, for financial reporting, IASB states that "Financial reports are prepared for the users that have sufficient knowledge concerning business and economic activities and that examine and analyze information with due care" and it is added : "...sometimes, even the well-informed and careful users need to seek the assistance of a counselor in order to understand the information on complex economic phenomena"[2]. However, accepting that the target public for IFRS financial statemetns is narrower than some critics might expect, we agree that the usefulness of these financial statements to investors and analysts could be strengthened by providing greater focus on these in the company's fiancial report.

Legitimate concerns about the usefulness of the company's annual report as a whole and the usefulness of the financial report, as well as their components as two different reports indicate that there are two main reasons: the growing trend for financial and material information so-called ”inconsistent information (templates) ” to be included in financial statements, and the inclusion in the annual report of additional information that are not required by IFRS.

There has been a tendency for the inclusion of immaterial information in the

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[1] It comes from the translation of "mum and dad investors" and designates a smaller group of non-professional investors, namely the persons that hold or desire to purchase shareholders, but have little experience or knowledge

[2] IASB (2010) The general conceptual framework for financial reporting, Paragraph QC32, available online at http://www.minfin.md/common/actnorm/contabil/standartraport/35323_RO_Conceptual_Framework_2011.doc.

financial statements. IFRS are clear on this point: the companies are obliged to comply with the requirements for recognition, assessment and submission demanded by IFRS if the failure to do so would lead to omissions or misstatements that could influence the economic decisions the users make based on the information in financial statements. Unfortunately, an ever greater number of companies choose to include all the information contained in IFRS, without applying this materiality test. This could be due to a number of reasons, but most likelty it is the fear of making a decision, which later proves to be wrong and could subject the Managing Board to litigation and/or to avoid prolonged talks with the company's auditors. There is also a growing trend within commpanies to include templates (standardized information) in their financial statements. This information required to be disclosed under IFRS needs the exercise of judgment, for example, disclosure of information concerning the sources of estimated uncertainties, which the companies, in cooperation with their auditors "standardize", in order to reduce the risk of litigation. Through the "purification" of this information, companies make financial statements less useful to investors.

The concerns about information excess in annual and financial reports come from a great number of sources. The inclusion of immaterial information in financial statements, previously mentioned is one. Another aspect is to include information that is not required under IFRS reporting in another section of the annual report. Another representative source regarding the "excess of information" in the financial report is given by the sbumission of potentially irrelevant information required by IFRS. When IASB establishes new standards or modifies the existent standards will be usually added to the amount of necessary information. IASB rarely submits these requirements of financial information disclosure to a critical assessment concerning their relevance to investors and analysts. One of the reasons for failing to do so is the lack of a "conceptual framework" to assess disclosures. In acest context, IASB has signalled the intention to develop a "framwork for information disclosure", as part of the conceptual framework project.

Finally, the difficulties ecountered by investors and analysts in understanding the information in financial statements may be caused by the accounting standards that are poorly designed. The poorly designed standards, when applied, cannot produce information on complex transactions that is transparent and easy to understand and can have as effect the perception of complex financial statements.

The poorly designed standards are often the result of including the requirements based on rules and of other requirements derived from the compromises made with the electors of standardization bodies. When the detailed rules are included in accounting standards, this is due to the concerns about less prescriptive requirements (known by the name of "principles"), which the formulators abuse of in the financial statements preparation. Ironically, the ones that desire to engage themselves in an opportunistic behavior find rule-based standards easier to "fool" than the principle-based standards, such as those in the United States of America. The requirements that reflect compromises are sprung from the desire to achieve a result that could not be the ideal approach of the standardization bodies, but which will lead to an improvement in the financial reporting. IFRS are not free from rule-based requirements as they are neither free from requirements led by compromises. Many of these standards have been improved as early as the beginning of IASB in 2001. However, certain deficiencies that are the cause of complextiy in financial reporting are maintained. Since its inception, IASB has endeavored to develop IFRS by using an approach based on principles and has seekd to reduce to minimum the adverse impact of outcomes based on comprise. However, the convergence program with FASB threatens to undermine its attempts to do so, due to the tendency of FASB to rather support rules, and du to the inevitable compromises resulting from the combination of the two types of independent standards to reach to convergent solutions. To the interest of creating more tranparent and easy to understand financial statements, IASB should try and resist this thereat in designing its standards, specifically IASB should discontinue the convergence project with FASB as soon as possible.

## 4. Conclusions

Regardless of the authors' vision on agency theory, **financial information is a key-element of the relationship between entity and its investors,** whether they are shareholders of creditors. The positive agency theory can highlight potential conflicts emerging from these relationships, and the research done on this topic suggests mechanisms for solving these conflicts. Among the conflict sources, asymmetric information is visibly the most importantem and the different regulations adopted, after getting aware of the problem, contributes to the effects limitation. The conceptual basis of IAS/IFRS standards first retains the approach to "investors" of the agent relationship, while entity has implicit or explicit contractual relations, with a series of partners.

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